

FITCH RATES HOWARD COUNTY, MD'S \$181.905MM GOS 'AAA'; OUTLOOK STABLE

Fitch Ratings-New York-15 March 2018: Fitch Ratings has assigned a 'AAA' rating to the following Howard County, Maryland bonds:

- \$140.98 million consolidated public improvement project bonds, 2018 series A (tax-exempt);
- \$1.025 million consolidated public improvement project bonds, 2018 series B (taxable);
- \$39.9 million metropolitan district project bonds, 2018 series C.

Bond proceeds will be used to reimburse the county for the cost of public improvements and to repay all or a portion of the county's outstanding general obligation (GO) bond anticipation notes.

The bonds are scheduled to sell on a competitive basis April 4.

The Rating Outlook is Stable.

In addition, Fitch has affirmed the following ratings:

- Issuer Default Rating (IDR) at 'AAA';
- \$1.6 billion outstanding GO bonds at 'AAA'.

SECURITY

The GO bonds are payable from the county's full faith and credit pledge and its unlimited taxing power.

ANALYTICAL CONCLUSION

The 'AAA' IDR and GO rating reflects the county's strong economic and revenue growth prospects, low long-term liability burden, healthy reserves, and broad budgetary tools.

Economic Resource Base

Howard County is a wealthy Baltimore-Washington, D.C. suburban enclave with a diverse economy of its own. As of 2016, the county's population was 317,233 and has increased at a CAGR of approximately 1.7% since 2010.

KEY RATING DRIVERS

Revenue Framework: 'aaa'

Revenues have been rising at a pace well above the rate of U.S. GDP growth and Fitch expects this trend to continue. The county has the independent legal ability to raise property tax revenues without limit contributing a superior level of inherent budget flexibility.

Expenditure Framework: 'aa'

Education drives the county's spending needs and are somewhat inflexible in that any reduction in funding levels would require approval from the state. Nevertheless, the county's ability to make spending cuts when needed is solid given its strong legal control over employee-related costs and staffing levels. Carrying costs related to debt, pensions and other post-employment benefits (OPEB) are moderate.

Long-Term Liability Burden: 'aaa'

The county's liability burden is largely debt driven and low relative to its expansive resource base. Future debt needs are manageable despite expectations for continued growth in population and service demands.

Operating Performance: 'aaa'

Fitch expects the county to maintain a high level of fundamental financial flexibility throughout economic cycles based on its expenditure and revenue flexibility and expectation for compliance with a conservative fund balance policy. Financial operations are supported by solid economic and revenue prospects.

RATING SENSITIVITIES

MAINTENANCE OF STRONG FINANCIAL PROFILE: The rating assumes the county's continued strong financial flexibility, revenue growth prospects and budget controls.

CREDIT PROFILE

The county is among the wealthiest in the nation, featuring a highly educated workforce employed throughout a deep and diverse economy, led by the federal government. Fort Meade, located in nearby Anne Arundel County (AA+/Stable), is a major driver of long-term regional growth and Maryland's top employer. The fort, already a home base to all five military services and several federal agencies including the National Security Agency, has been named the headquarters for the U.S. cyber-security center. The county estimates that federal agencies located at Fort Meade employ approximately 12,500 county residents.

The education and healthcare sectors, led by John Hopkins University Applied Physics Laboratory, play a pivotal role in the economy and lend diversity to the notable concentration in government. While employment growth has slowed, the county continues to generate and retain jobs through its economic development efforts. The unemployment rate remains below the state and national averages.

The county continues to focus its economic development efforts in downtown Columbia where Tenable, Inc., a cybersecurity software company, recently announced its plan to expand its company headquarters increasing its employment to 950 employees.

Revenue Framework

Property taxes are the largest revenue source for the county at 50% of general fund revenues followed by income taxes at 42%. Homes values have consistently increased over the past five years according to Zillow and the one-year forecast shows a 1.4% increase. Assessed values, which lag the actual housing market due to the statutory rolling three-year reassessment cycle in Maryland, have increased consecutively over the past four years, including a 2% increase in fiscal 2018 to \$50.6 billion.

According to audited fiscal 2017 results income tax revenues increased for the seventh consecutive year. However, adjusted budgeted income tax revenue data reflects a decline (3% budget to actual) during fiscal 2018. The county is projecting a 4% increase in income tax revenue in fiscal 2019.

The county's natural pace of general fund revenue growth has trended above U.S. GDP growth without any tax policy changes in over a decade. Given ongoing economic development as well as positive housing and employment trends, revenue growth prospects are strong.

The county is not subject to any limitation on its property tax rate or levy and has not increased the property tax rate in 16 years. The income tax rate was increased in 2004 to the maximum rate of 3.2%.

Expenditure Framework

The county's largest expenditure is education at roughly 59% of general fund expenditures, followed by public safety at 12%.

Based on the county's history of structural balance and no immediate significant spending pressures, Fitch expects spending growth to remain in line with revenues.

According to the state's maintenance of effort (MOE) mandate, education spending cannot decline year-over-year without state approval. Approximately 50% of the county's workforce is unionized with one-or two-year contracts. However, strikes are not permitted and arbitration is not binding on the county council's budget.

Carrying costs associated with debt service, actuarially determined pension payments (including the normal cost for teachers' pensions) and OPEB actual contributions totaled about 15% of fiscal 2017 governmental spending; debt service accounted for about 9%. Given the county's plan to increase its contribution to OPEB carrying costs should increase but flexibility of main expenditures is expected to remain solid.

Long-Term Liability Burden

Overall net debt plus the county's unfunded pension liability approximates a low 7% of personal income excluding self-supporting metropolitan district utility debt. Debt ratios increase slightly to nearly 8%, including metropolitan district debt, which is paid from special assessments and charges levied against all property in the district for utility purposes. While operating revenues (water and wastewater) historically have been sufficient to cover metropolitan district operating expenses and debt service, during fiscal 2017, the district utilized enterprise fund balance to fund operations including the payment of debt service. The general fund does not provide support to utility operations and the metropolitan district fund maintains good legal rate-setting flexibility and liquidity. Utility rates are subject to county council adoption, and have not been increased since 2014 (there is currently no plan to increase rates). As of fiscal year-end 2017, current cash on hand in the metropolitan district fund exceeded \$35 million or more than 140 days of operations.

The county will repay over 60% of outstanding principal within 10 years, leaving adequate capacity to fund future borrowing needs. The county's fiscal 2019-2023 capital plan totals \$1.3 billion, excluding utility-related projects. While the plan includes nearly \$1 billion of bond proceeds, the county expects actual future borrowing to approximate \$100 million annually, allowing the county to maintain debt service costs at 10% of revenue or less. Although the amount of total debt outstanding is expected to increase, increasing personal income should keep the long-term liability ratio comfortably within the 0%-10% guidance for a 'aaa' key rating factor assessment.

The county provides pension benefits to its employees through two single-employer defined benefit plans, a general employee plan and a fire and police plan, and annually makes the actuarially determined contribution (ADC) to each. As of July 1, 2017, the general employees' plan was funded at 86% and police and fire employees at 76%. Fitch estimates the funded ratios at approximately 72% and 62%, respectively, using Fitch's standard 6% discount rate compared to the plans' rate of 7.5%. The Fitch-estimated aggregate adjusted net pension liability totaled approximately \$447 million or about 2% of personal income. The county also provides a length of service plan for volunteer public safety employees, which is currently unfunded but has a minimal net pension liability.

The county administers an OPEB trust fund that provides benefits for its retirees, which has a balance of about \$105 million as of fiscal year-end 2017. As of the 2016 valuation the unfunded liability is \$908.5 million or a moderately high 4% of personal income and the plan is 10% funded.

The county has increased funding annually (reaching \$36 million or 38% of the ADC in fiscal 2017) and expects to reach full funding by 2025-2026.

Operating Performance

Fitch assesses the county's inherent budget flexibility as superior given the county's strong legal ability to increase revenue and reduce expenditures. In response to a weak revenue growth environment during the last recession, the county used reserves to balance operations. During the recovery the county rebuilt reserves to currently healthy levels.

The unrestricted general fund balance of \$125.5 million at fiscal year-end 2017 was equal to 11.9% of spending, following an approximately a \$2.7 million operating deficit due to flood recovery efforts in Ellicott City. The unrestricted fund balance includes the county's budget stabilization reserve, which is held within the committed fund balance and according to county charter is to be maintained at 7% of general fund spending. During fiscal 2017, the county established an additional reserve with an initial \$5 million contribution in the assigned portion of the fund balance. The county plans to increase the reserve to 3% of general fund spending from 1% at year-end 2017 over the next 10 years.

The county funds fire and rescue and recreation services outside of the general fund. When Fitch combines these funds with the unrestricted general fund the available fund balance increases reserves to \$144.6 million or 13% of combined spending at year-end 2017.

The Fitch Analytical Sensitivity Tool (FAST) produces a modest decline in revenue in the first year of a moderate economic downturn followed by a prompt rebound based on the county's historical general fund revenue performance. The county's financial position should remain solid throughout the economic cycle given strengthened reserves and conservative management practices.

The fiscal 2018 budget is a 3.6% increase over fiscal 2017 and includes a \$9.9 million fund balance appropriation while maintaining the property and income tax rates. The budget increases included \$2.9 million above the MOE required level for education, an additional \$3 million for county employer OPEB over the fiscal 2017 total contribution, and a cost of living salary increase. The budget also funds \$281 million for capital in the form of pay-go and bond financed spending. According to management, year to date operations are in line with budget. Based on the county's multi-year financial forecast, Fitch expects operations to be balanced and reserve levels to remain above the county's 7% policy.

Year-to-date operating results show income tax revenues \$12.2 million under budget (approximately 1% of the approved fiscal 2018 budget). According to management, weakened income tax revenue is due to deferral of capital gains income during tax year 2016 in anticipation of the newly implemented federal tax plan. County management has implemented a \$7 million cost reduction plan to address the shortfall that includes savings from a debt refunding, vacancy savings, a slow-down in hiring and various operation cost savings. The difference in the revenue shortfall and the savings plan is expected to be made up with positive variances in other revenue sources. Management is projecting an increase in income tax revenues during fiscal 2019 as taxpayers realize capital gains deferred during tax year 2016.

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In addition to the sources of information identified in Fitch's applicable criteria specified below, this action was informed by information from Lumesis and InvestorTools.

Applicable Criteria

U.S. Public Finance Tax-Supported Rating Criteria (pub. 31 May 2017)
<https://www.fitchratings.com/site/re/898466>

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